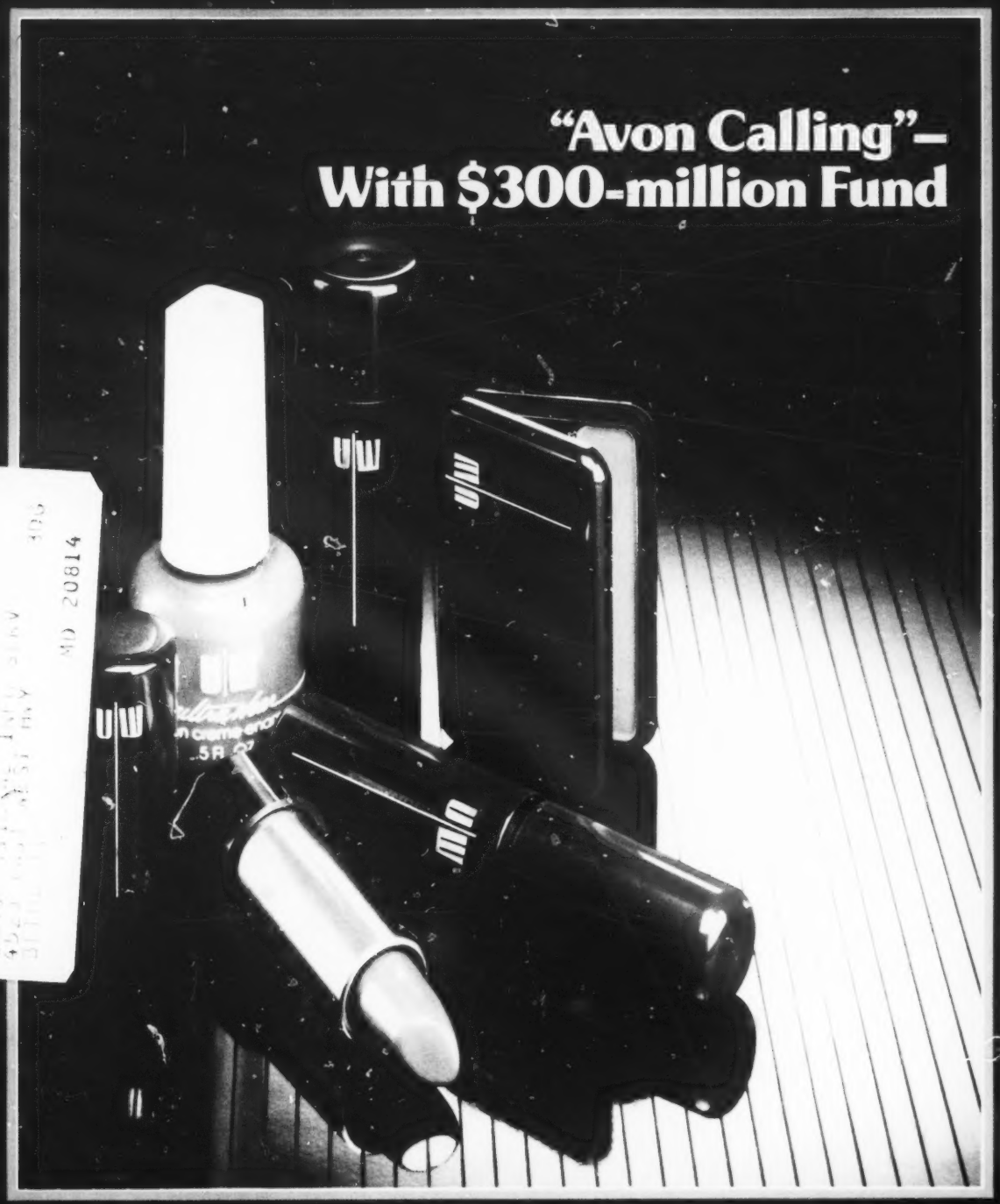
FEBRUARY 1984

Pension World

The Magazine for Plan Sponsors and Investment Managers/ A Publication of Communication Channels, Inc.



"Avon Calling"— With $300-million Fund

Using ESOP's to Thwart Takeovers

Guide for Screening Managers

Pension World

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Volume 20 Number 2

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Features

Plan Sponsor Focus: "Avon calling"—with $300-million fund by Ronald Derven **15**
Two executives of Avon Products—the vice president/taxes and the director/treasury planning—discuss the strategy, goals, and investment management philosophy in the new direction of the firm's $300-million pension fund.

Corporate Strategy: Using ESOP's to thwart hostile takeovers—beware! by Corey Rosen and Michael Caudell-Feagan **18**
The development of "takeover defense" Employee Stock Ownership Plans has mixed implications for the future of employee ownership. Some of this action has been labeled "MESOP's"—management entrenchment stock ownership plans. What are the positive and negative effects of using ESOP's as defense strategy?

Investment Management: Updated guide for screening managers by Brian Rom **22**
A definitive way of screening investment managers to determine which ones to consider in investment manager selection can be a big help to plan sponsors. This study, an updated follow-up to a study published in this magazine in 1981, is expanded to include international management firms.

Investment Management: Beyond the efficient market: a free lunch by David A. Baker **25**
Earning superior stock market returns by investing in small capitalization stocks has been a great strategy in the past. It was well worth the extra risk. But now, could the market be at an exceptional point in history where an investor might earn more by taking less risk?

S&L's continue expertise in mortgage lending by Dallas Bennewitz **27**
Although many changes have occurred in the savings industry, one item remains constant: savings institutions still specialize in mortgage lending. This article examines what some of the changes have brought and what the "new" savings institutions have to offer.

Current Issues in Plan Design: Women and pensions: what Congress is doing about them by Judith Mazo **30**
What will the "pension equity" legislation that is on the horizon do for women? What will it cost? Will it increase the prospect for women to receive a greater share of private sector retirement plan benefits? Will men also profit from some of this legislation?

Pension World Basics: Universal life insurance in a 401(k) savings plan by Joel I. Rich **37**
This article explains what is involved in using universal life insurance in a 401(k) savings plan. The advantages may outweigh the disadvantages, but the plan sponsor must be sure of the legal basis for including it in a firm's program.

Departments

Guest Editorial	4	Perspective on Investments	13	Pension People	43
International Pension World	6	Cases & Rulings	35	Meetings & Conventions	46
Washington Newsletter	8	Pension News	39	Pension Resources	47
				Arbitration Awards	50

Cover: **With more than a million Avon representatives, "Avon calling" is certainly a familiar phrase. The story of Avon's pension fund strategy begins on page 15.**

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ISSN 0098-1753

Pension World is published monthly by Communication Channels, Inc., Tim Gold Blyth, Chairman of the Board; B.J. Kotsher, President; Russell Richards, Secretary; John Moebius, Treasurer. Editorial and advertising offices at 6255 Barfield Road, Atlanta, GA 30328. Telephone (404) 256-9800. Telex 4611075COMCHANL. *Pension World* is a registered trademark of Communication Channels, Inc.

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Second class postage paid at Atlanta, GA, and at additional mailing offices. Subscription rates: U.S.A., 1 year, $38; 2 years, $63; Canada and Mexico, 1 year, $41. Foreign Sea Mail, 1 year, $48; Foreign Air Mail, 1 year, $78. Single copies, $3.50. Group rates available. The opinions expressed by authors and contributors to *Pension World* are not necessarily those of the editors or publisher. Articles appearing in *Pension World* may not be reproduced in whole or in part without the express permission of the publisher. Microfilm copies of *Pension World* are available from University Microfilms, 300 North Zeeb Road, Ann Arbor, MI 48106. Postmaster: Please send form 3579 to Circulation Department, *Pension World*, 6255 Barfield Road, Atlanta, GA 30328.

An updated guide for screening managers

No matter what size the fund is, in selecting new investment managers for its pension fund, the plan sponsor needs a rational method to determine which managers to consider for the assignment.

One of the most frequent tasks of pension plan sponsors is that of selecting new investment managers for their trust assets. Whether the asset pool is large or small and whether the search is for a firm to manage all or part of the assets, the sponsor needs a rational method to determine which managers to consider for the assignment. To avoid wasting time meeting and evaluating a poorly constructed group of managers, it is imperative to have a process by which the large universe of possible candidates can be reduced to a manageable number.

A systematic screening process to assist clients in addressing this and related questions has been developed by the Investment Supervision Group at Peat Marwick Mitchell. This article, a follow-up to a study published in *Pension World* in March, 1981, explains that process and reports on the results of the most recent screenings of several hundred U.S. and international investment firms. This current study has been expanded to include international equity and fixed-income management firms, in addition to their U.S. counterparts.

Given the mass of qualitative and statistical data that can be assembled for each of the candidates, judiciously applied screens of historical investment results are an effective way to help cull the universe of all managers to the desired size. It needs to be emphasized that this performance criterion is a first screen only, helping to reduce the number of managers requiring further analysis, which starts once the screening has been done. In other words, the screening process is not intended to be a replacement for careful evaluation of investment philosophy and process.

A further important consideration is the degree to which certain investment styles have been favored in a particular time period. For example, managers of smaller and special situation equity portfolios did far better than regular equity funds in the five years of 1978-82, covered in this study (the median results of the Peat Marwick data base are 27.7 percent and 19.9 percent, respectively). It follows then, that in evaluating the results of the screen, consideration should be given to an equity manager's style orientation and not the investment environment for that style during the period under consideration.

Also, in evaluating management firms that have survived the screen, it must be determined that the personnel who achieved the performance remain responsible for the major investment decisions at the firm. If a significant number of the key players have left, it may be essentially a new firm.

In using these historical data, care must also be taken to reduce the effect of the most recent performance on the selection decision. This can be done by looking at performance over a number of time periods, not all of which have the same end point. Multiple time periods have been used because any single period might indicate market, not manager results. For example, bond managers who had heavy cash positions in 1981 would have had excellent results relative to other bond managers, but how did they do in 1982 when longer maturities did so much better than shorter maturity portfolios? The multiple-period screen can provide some answers to these questions.

Tables 1,2,5,6,7, and 8 show the time periods, median returns, and the screening criteria for each of the U.S. and international equity and fixed-income universes used. These screens are particularly rigorous as is shown by the median manager's substantial incremental return over the market in most cases. Note that this process is based on a negative screen: those firms that over a number of different market environments have consistently underperformed their peers are eliminated from further consideration.

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For example, in the case of the U.S. managers, this is translated into the following screening rule: Eliminate all organizations whose results do not exceed the median of the entire universe in at least three of the five time periods used.

Table 3 shows the results of this screen on 173 equity managers and 104 fixed-income managers, each with at least $50 million in tax-exempt assets under management. The results indicate that nearly equal proportions of each universe survived the screens and in both categories, counselors as a group have the best historical record when compared with banks and insurance companies—more than half the counselors survive as compared to a less than one-third success rate for the other two manager categories. This suggests that the independence enjoyed by counselors is a positive factor in the highly competitive investment world.

It is interesting to note also that the banks' success ratio in fixed income is nearly double that of their equity rate. Since the banks surveyed generally manage more equity assets than do the counselors, this supports the contention that, at the extremes of smallness and largeness, success in equity management (more so than in bond management) is inversely related to the size of the asset pool being managed.

This observation is also supported by the data in Table 4. The success rate for very large equity managers is about three-quarters of that for smaller managers. It is, however, instructive to note that there is no appreciable difference between the success rates of those firms managing less than $1 billion

Table 1 U.S. Equity Manager Performance Screens

Time Periods	Peat Marwick Universe Median	S&P 500 Index
1 Year: 1982	24.4%	21.6%
3 Years: 1980-1982	17.6	15.3
5 Years: 1978-1982	16.8	14.2
Peak to Peak Market Cycle — 4 Years: 1977-1980	14.7	11.6
Trough to Trough Market Cycle — 4½ Years: 4/78-6/82	13.5	10.8

Screening Criterion: Eliminate manager if not above universe median in at least three of the five time periods.

Table 2 U.S. Fixed-Income Manager Performance Screens

Time Periods	Peat Marwick Universe Median	Lehman Bros. Kuhn Loeb Govt./Corp. Index
1 Year: 1982	29.5%	31.7%
3 Years: 1980-1982	12.7	13.2
5 Years: 1978-1982	8.7	8.4
Falling Market — 4¾ Years: 1/77-9/81	1.9	1.4
Rising Market — 1¼ Years: 10/81-12/82	32.6	34.3

Screening Criterion: Eliminate manager if not above universe median in at least three of the five time periods.

Table 3 U.S. Managers Passing Performance Screen: By Type of Firm

Type of Institution	Equity Managers: Number Screened	Equity Managers: Number Surviving Screen*	Equity Managers: Percent Surviving	Fixed-Income Managers: Number Screened	Fixed-Income Managers: Number Surviving Screen**	Fixed-Income Managers: Percent Surviving
Banks and Trust Companies	56	8	15%	50	13	26%
Independent Counselors	104	53	51	46	24	52
Insurance Companies	13	4	31	8	1	13
Totals	173	65	38%	104	38	37%

* See Table 1
** See Table 2

Table 4 Managers Passing Performance Screen: By Size of Firm

Size of Institution(*)	Equity Managers: Number Screened	Equity Managers: Number Surviving Screen**	Equity Managers: Percent Surviving	Fixed-Income Managers: Number Screened	Fixed-Income Managers: Number Surviving Screen***	Fixed-Income Managers: Percent Surviving
Medium ($50 million — $1 billion)	127	49	39%	75	27	36%
Large ($1 billion — $2.5 billion)	26	10	38	18	7	39
Very Large ($2.5 billion & up)	20	6	30	11	4	36
Totals	173	65	38%	104	38	37%

* Total equity or fixed-income tax exempt assets, respectively, under management
** See Table 1
*** See Table 2

Table 5 Foreign (i.e., Non-Dollar) Equity Manager Performance Screens

Time Periods	Peat Marwick Universe Median	Capital International EAFE Index
6 Months: 1/83-6/83	14.8%	14.1%
1 Year: 6/82-6/83	39.3	31.3
2 Years: 6/81-6/83	5.8	5.8
3 Years: 6/80-6/83	9.2	7.0
5 Years: 6/78-6/83	13.4	11.2

Screening Criterion: Eliminate manager if not above universe median in at least three of four or three of five, or two of two or two of three time periods.

Table 6 Global Equity Manager Performance Screens

Time Periods	Peat Marwick Universe Median	Capital International World Index
6 Months: 1/83-6/83	17.4%	18.6%
1 Year: 6/82-6/83	47.8	49.2
2 Years: 6/81-6/83	10.5	13.3
3 Years: 6/80-6/83	11.7	13.4
5 Years: 6/78-6/83	12.0	14.9

Screening Criterion: Eliminate manager if not above universe median in at least three of four or three of five, or two of two or two of three time periods.

Table 7 Eurodollar Bond Manager Performance Screens

Time Periods	Peat Marwick Universe Median	Salomon Brothers Eurodollar Bond Index
6 Months: 1/83-6/83	6.5%	6.8%
1 Year: 7/82-6/83	23.4	30.9
2 Years: 7/81-6/83	18.6	19.8
3 Years: 7/80-6/83	14.3	11.7
5 Years: 7/78-6/83	13.0	9.0

Screening Criterion: Eliminate manager if not above universe median in at least three of four or three of five, or two of two or two of three time periods.

Table 8 Global Bond Manager Performance Screens

Time Periods	Peat Marwick Universe Median	Salomon Brothers World Bond Index
6 Months: 1/83-6/83	4.2%	6.3%
1 Year: 7/82-6/83	21.0	25.5
2 Years: 7/81-6/83	17.8	18.7
3 Years: 7/80-6/83	11.3	12.2
5 Years: 7/78-6/83	7.4	4.0

Screening Criterion: Eliminate manager if not above universe median in at least three of four or three of five, or two of two or two of three time periods.

Table 9 Funds Of International Equity And Bond Managers Passing Performance Screen

Type of Fund	Number Screened	Number Surviving Screen*	Percent Surviving
Foreign (i.e., Non-Dollar) Equity	31	14	45%
Global Equity	16	7	44
Eurodollar Bonds	34	16	47
Global Bonds	16	6	38

* See Tables 5, 6, 7, 8

and those managing between $1 billion and $2.5 billion.

Some of the ways the size of assets under management may have caused the differences noted above include restricting a manager's ability to own smaller capitalization stocks (which were generally favored during the period covered by this study). A further benefit of smaller assets under management is flexibility. In periods of rapidly changing relative performance among different market sectors, the ability of managers to rotate their assets among these sectors can be a major determinant of their investment performance; managers of smaller portfolios will generally have had greater flexibility in making these changes. Although these differences may not continue into the future, they provide some indication of a manager's past ability to adapt to changing conditions.

As in the domestic screening, the international screens are designed to eliminate the consistent underperformers.

The fixed-income results are in keeping with expectations. Size is a relatively insignificant factor in discriminating between bond managers.

Turning to the international manager results, Tables 5 through 8 provide the screening criteria for each of the four universes: foreign equity, global equity, Eurodollar bond, and global bond. Due to the smaller number of firms with the appropriate data, the screening conditions are generally easier than in the domestic case. However, as in the domestic case, the international screens are designed to separate out the consistent underperformers.

Table 9 summarizes the screen of international equity and bond managers. The numbers represent the basic universe from which managers for specific search projects are selected.

The straightforward process described in this article can go a long way toward increasing the efficiency of the plan sponsor's search for an investment advisor. □

S&L's continue expertise in mortgage lending

After they have weathered the toughest period in their history, the "new" savings institutions business entails much more than the traditionally held view of being the nation's major source of home loans.

Now that savings and loan associations and savings banks have successfully weathered the toughest period in their history, many pension fund executives are taking a fresh look at what is being called the "new" savings institutions business and what it has to offer.

Financial deregulation has resulted in a variety of changes within the savings industry, including expanded lending authorities and removal of interest rate controls on most savings accounts, but there remains an important constant: Savings institutions still specialize in mortgage lending.

The continued concentration on mortgage credit is good news for both investors and home buyers. Savings institutions traditionally have been the nation's major source of home loans, and the business originated more than half of all residential mortgage loans during the second quarter of 1983, the latest period for which data are available.

Secondary mortgage market

For home buyers, that means a steady source of home financing capital. For pension fund managers, the savings institutions' commitment to mortgage lending means the continued availability of a prime investment vehicle—first mortgages on residential property. Home mortgages are perhaps the safest investment a fund manager can make. And the long-term nature of mortgage loans makes these investments an ideal match for pension fund money, a basic reason for the increasing involvement of pension funds in the secondary mortgage market.

Non-traditional mortgage investors (including pension funds and insurance companies) have played a more significant role in home finance through the purchase of mortgages and mortgage-related securities since 1978, the year in which the secondary mortgage market is said to have come of age (see Chart 1). Between 1970 and 1977, non-traditional investors, on average, accounted for only 4.2 percent of total home mortgage originations, according to "Financing Homeownership in the 1980's," a discussion paper published by the Homeownership Task Force of the United States League of Savings Institutions. Since then, however, this percentage has ranged between 12.2 percent and 17.3 percent. In dollar terms, non-traditional mortgage investors have poured between $13.9 billion and $32.8 billion into the mortgage market annually since 1978.

Through the first half of 1983, pension funds and other non-traditional mortgage investors acquired $14.3 billion of mortgages and mortgage-backed securities, or 15.4 percent of total originations. If this pattern continued during the July-through-December period, 1983 could approach a new record year for acquisitions by pension funds and other non-traditional mortgage investors.

That's not surprising. Secondary mortgage market activity has increased significantly in recent years. Taken as a percentage of mortgage originations by all lenders, secondary market sales of mortgages have doubled, rising from an average of 26 percent in the period from 1970 through 1977 to an average of 52 percent in the period from 1978 through the first half of 1983.

In 1982, mortgage sales as a percentage of originations reached 88.6 percent. Through the first half of 1983, sales as a percentage of originations remained at a high 69.5 percent.

The high asset quality of home mortgages is reflected by the low delinquency rate on these loans. During the past 20 years, the national delinquency rate on residential mortgages outstanding at savings institutions has averaged just 0.93 percent. Put another way, the data show that more than 99 percent of all homeowners have made their mortgage payments on time each month. Even during the most recent economic downturn, mortgage delinquencies never exceeded 1.4 percent. The timely payment record should not come as a surprise since homeowners realize that a home not only provides shelter but also an important investment.

Home mortgages obviously are a good investment for pension funds, too. Long-term, fixed-rate mortgages provide guaranteed cash flow over an extended time period. Many savings institutions have packages of fixed-rate home loans available

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for sale in a variety of dollar amounts and terms designed to fit different investment needs.

Adjustable rate mortgages

The fixed-rate mortgage has been the standard form of home financing in the United States ever since the 1930's and has made it possible for millions of households to become homeowners. The fixed-rate mortgage, however, was designed to meet home financing needs in an era when mortgage lenders could rely on a steady supply of low-cost savings deposits—mostly in passbook accounts. Fixed-rate mortgages worked well for lenders as long as interest rates were stable.

However, with savings rates linked to the money markets, thanks to financial deregulation, and with those interest rates more volatile than in the past, lenders no longer can rely on fixed-cost, stable supplies of money to fund long-term, fixed-rate mortgages. That is why savings institutions have developed adjustable rate mortgages—or ARM's as they are popularly known. These flexible loans, which permit adjustments in the interest rate to match changes in the economy, have become popular with home buyers and offer a significant advantage to pension funds and other investors who purchase the loans in the secondary mortgage market.

Since the interest rate on an ARM can move up or down, keeping pace with market rates, investors purchasing these loans are ensured that their yield will always stay in sync with the market. Several important consumer benefits make ARM's attractive to home buyers, too, as evidenced by the sharp increase in the popularity of these loans last year. During the first quarter of 1983, adjustable mortgages accounted for just 23.3 percent of all mortgages made by savings institutions. By October, however, ARM's represented 50 percent of all mortgage lending, and as the end of the year approached, the figure continued to grow.

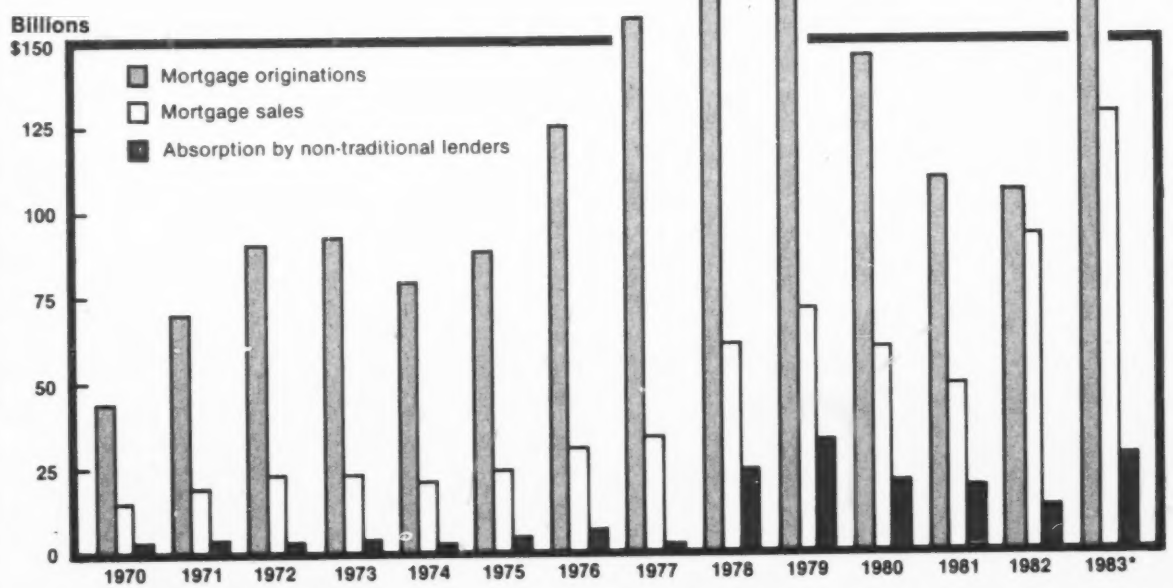
With savings rates linked to the money markets, thanks to financial deregulations, and with those interest rates more volatile than in the past, lenders no longer can rely on fixed-cost, stable supplies of money to fund long-term, fixed-rate mortgages. That is why savings institutions have developed adjustable rate mortgages — or ARM's.

ARM's popularity grows

There are several reasons for the growing popularity of ARM's. The initial rate on an adjustable rate home loan often is lower than with a fixed-rate mortgage, because the borrower is sharing some of the interest rate risk with the lender. In many cases, point charges (service and processing fees) also are lower.

For a home buyer, the lower ARM rate can mean the difference between qualifying for a loan or being rejected. For example, a home buyer choosing a $60,000 adjustable mortgage at 12 percent interest would have monthly payments of $617.17, compared with $687.25 for a $60,000, 30-year, fixed-rate loan at 13.5 percent. The $70.08 per month difference could

Chart 1 Secondary Mortgage Market Activity



*First-half of year annualized.

Sources: Dept. of Housing and Urban Development, Federal Home Loan Bank Board, Federal Home Loan Mortgage Corp., Federal National Mortgage Assn., Government National Mortgage Assn., National Assn. of Mutual Savings Banks, and U.S. League of Savings Institutions.

be the deciding factor in whether the home buyer is able to qualify for the loan, especially if the buyer is stretching his, or her, budget to the limit.

Another benefit of ARM's is that they can be assumed—an important benefit when today's home buyer goes to sell.

Over the coming years, ARM's are expected to play an increasingly important role in the restucturing now underway at savings institutions.

Restructuring, lower and less volatile interest rates, and expanded customer service authorities are working in concert to strengthen savings associations and savings banks. And the new types of mortgage loans, which have interested many secondary market investors, are very much a part of the "new" savings institutions business. So is the insured money market deposit account (MMDA).

Money market deposit account

Introduced in December, 1982, the MMDA was almost solely responsible for the record savings deposit gain at savings institutions last year. Although year-end data were not available as this article went to press, deposit growth during 1983 seemed certain to reach $100 billion. That would double the 1977 record when deposits grew $50.2 billion. According to figures from the U.S. League's research department, net new savings deposits grew $57.8 billion through the first 10 months of last year (1983).

Net new savings are the difference between actual savings deposits and withdrawals; the figure does not inciude interest credited to accounts. When savings account interest is added, the business' total savings gain for 10 months was $94.4 billion. The 1977 record included interest credited. Excluding interest, deposit growth in 1977 totaled $32 billion (see Table 1).

The striking impact of the insured MMDA can be seen in Table 2, which shows that between January, 1982, and November, 1982, savings withdrawals exceeded deposits by $18.1 billion. During December, 1982, however, the first month the MMDA was available, new deposits topped withdrawals by $10.4 billion.

The Garn-St. Germain Depository Institutions Act of 1982 was responsible for the creation of the MMDA. The legislation also allowed savings institutions to expand their consumer lending activities, participate in real estate development projects, and begin making loans to businesses and for agricultural purposes.

During the first 10 months of 1983, the first year the new powers were available, savings institutions loaned a record $111 billion in mortgage money to home buyers, exceeding the previous record level of lending set in 1978.

The expanded lending authorities are important and certainly are needed, but they will not sidetrack savings institutions from their primary area of expertise which is mortgage lending.

During the first 10 months of 1983, the first year the new powers were available, savings institutions loaned a record $111 billion in mortgage money to home buyers. In dollar terms, that already exceeds the previous record level of lending set during all of 1978 and was almost three times the $39.8 billion lent in the first 10 months of 1982 (see Table 3).

Continued strong demand for loans and increased deposit flows are expected to lead to improved performance by savings and loan associations and savings banks in 1984, making the "new" savings institutions business worth looking at. □

Table 1 Savings Institution Deposit Growth (in billions of dollars)

Year	Net New Savings	Interest Credited	Growth in Deposits
1976	$34.4	$15.4	$49.8
1977	32.0	18.2	50.2
1978	23.5	20.7	44.2
1979	15.0	23.9	38.9
1980	10.7	30.3	41.0
1981	– 25.4	38.8	13.4
1982	– 6.1	46.9	40.8
1983*	57.8	36.6	94.4

*Preliminary results for first 10 months.

Data are for FSLIC-insured institutions.

Source: Research Department, U.S. League of Savings Institutions.

Table 2 1982 Net New Savings* (in billions of dollars)

January	$ – 1.380
February	+ 0.761
March	– 1.284
April	– 4.588
May	– 0.302
June	– 3.262
July	– 0.938
August	– 1.718
September	– 1.801
October	– 2.947
November	– 0.637
December	+ 10.429

*Excluding interest credited.

Data are for FSLIC-insured institutions.

Source: Federal Home Loan Bank Board

Table 3 Mortgage Lending by Savings Institutions (in billions of dollars)

Year	Amount
1976	$ 77.1
1977	105.3
1978	108.3
1979	98.7
1980	71.3
1981	52.3
1982	54.3
1983*	111.1

*Preliminary results for first 10 months.

Data are for FSLIC-insured institutions.

Source: Research Department, U.S. League of Savings Institutions